Restoring Trust in Corporate Governance

Boards of directors and business leaders must undertake six essential tasks argues, Ben W. Heineman Jr.

By Ben W. Heineman Jr.

Editor’s Note: This article is adapted from the executive summary of a policy brief just published by the Committee for Economic Development, authored by Mr. Heineman and endorsed by the Millstein Center for Corporate Governance & Performance at Yale’s School of Management, the Caux Roundtable, and the Hills Program on Corporate Governance at the Center for Strategic & International Studies. The full brief can be read here.

The business community faces a crisis in confidence both in its own ranks and in broader society. Many are asking: How can corporations govern themselves more effectively—and truly be held accountable?

One answer is increased public regulation. The origins of the Great Recession include bad business decision-making caused in no small part by excessive and poorly structured corporate compensation. Not surprisingly, there are now energetic public policy debates about the governance both of the financial sector (with a variety of measures being considered to ensure safety and soundness) and of all publicly held corporations (with focus on an enhanced shareholder role and mandated compensation and risk processes).

But regardless of regulatory outcomes, boards of directors and business leaders will still have to make complex decisions that direct the destiny of corporations. In doing so, they must, in my view, discharge six essential, interrelated tasks which are the foundation for rebuilding trust in corporate governance and addressing the ultimate questions of corporate accountability which underlie the governance debates.

These do not fall under the category of “nice to do.” It is profoundly in the self-interest of private sector leadership energetically to implement these six “must do's” in order to answer powerfully the legitimate criticisms of board and senior executive decision-making in recent years.

The six tasks are:

1) A redefinition of the mission of the company—and the role of the board of directors and the CEO to create durable value for shareholders and other stakeholders through sustained economic performance, sound risk management and high integrity
The most basic purpose of the corporation is for leaders to find a sound balance between risk-taking (innovation and creativity) and risk-management (financial and operational discipline) and to fuse this high performance with high integrity. High integrity means a commitment to law, ethics and values in order to attain affirmative benefits inside the company, in the marketplace and in global society, but also to reduce legal, ethical, reputational, public policy and country risk. The emphasis on short-term maximization of shareholder value should be reduced significantly.

2) A revamped internal leadership training process

Such a process should be built on these integrated essentials of performance, risk and integrity—and on a culture in which all are honored and exemplified. Corporate education and training for potential leaders must be broadened and transformed; growth assignments must include diverse roles involving risk and integrity issues, not just making the numbers in different environments.

3) A refocused CEO selection process

This most important board function should flow from a revised leadership development process and seek a broader set of skills appropriate to a redefined mission. The board of directors should explicitly articulate a redefined role when seeking a new CEO.

4) A restatement of fundamental but operational measurements for performance, risk, and integrity

These metrics should expresses the near, medium, and long-term corporate goals across all three dimensions in both financial and non-financial terms. The primary focus should be on clear steps that create sustainable value for shareholders and other stakeholders, such as employees and customers, essential to the company's well-being.

These performance, risk, and integrity operational goals not only should guide internal actions but should be articulated annually in a public and transparent way so that external constituencies can assess accountability against clear standards.

5) A revision of compensation for the CEO and other senior executives

Such a revision for top business leaders—and for other employees with significant impact on the corporation—must be based on real actions measured against those restated operational performance, risk, and integrity objectives. Although top business leadership will receive substantial annual cash compensation, a significant proportion of compensation in any particular year will be variable cash and variable equity which will be paid out or held back over time as objectives are met, exceeded or missed.

6) A re-alignment of the board's fundamental oversight function

Boards often complain of too much complexity in their jobs. They should cut through the clutter and focus primarily on those high priority performance, risk and integrity operational objectives which are central to attainment of corporate mission and to assessing the fundamental actions on which executive compensation, over time, is based.
Corporations' current statements of purpose may make reference to these six fundamental tasks. But, the tasks may either be lost amidst many other corporate goals or may not be matched by robust practice. The harsh reality is that business organizations must be designed to check short-termism, greed, and corruption and to channel capitalism's innovation and "animal spirits" into sustained, durable creation of real economic value. It is the job of boards at a conceptual level and business leaders at both a conceptual and operational level to do so within a framework of financial discipline, law, ethics and values.

A relentless focus on these six fundamental tasks will drive creation of sustainable shareholder and stakeholder value—will provide an "actionable" framework for publicly held companies. Moreover, the development of appropriate executive compensation—the governance topic generating the most public heat today—can only flow from definition of corporate mission and articulation of related operational goals and measurements.

Directors in particular should put highest priority on these six tasks in defining a "right-sized" board role going forward. This will require focused intensity. But, the CEO and other senior company executives must also make these tasks the core of their leadership and management efforts as they "govern" the company on a day-to-day basis. If boards do their most fundamental tasks—define the mission of the corporation to include risk and integrity and choose the right CEO and senior executives according to that mission—then directors should be able to act as constructive critics with business leaders and forge a powerful board/executive partnership to direct the destiny of publicly held corporations.

There are, of course, significant obstacles. Directors and business leaders must candidly confront difficult, real-world issues which can undermine a corporation's will and ability to discharge the six tasks in a meaningful way. These problems include:

- competitors in the labor market for top executive and other business talent which can defeat structured compensation schemes by throwing money at valued individuals;

- differing regulatory standards in the overlapping U.S. jurisdictions and across the world—and the risk of regulatory arbitrage;

- the limitations of many current compensation consultants who may not understand the underlying reality of specific companies well enough to help design the operational performance, risk and integrity objectives upon which compensation should be based.

- the increasing short-termism of many institutional investors—who do not act as owners of individual companies or care about company fundamentals but instead respond to "fund manager" incentives to beat aggregate benchmarks (like the S&P).

- the dangers of gaming any system of measurements, including new ones advocated here.
Some thoughts on how to overcome these obstacles are outlined in the more extensive Policy Brief.

Finally, boards and senior executives must strive to carry out these tasks in good faith in order to address the fundamental issue of corporate accountability.

The pricing signals from the stock market, an enhanced shareholder role in governance and increased government regulation all may have a role in accountability. But all have imperfections, and all are the subject of strenuous debate. For example, given the enormous diversity in objectives, strategies and fund manager incentives, are shareholders part of the problem or part of the solution? If the efficient market theory must be modified by actual bubbles and irrationality—and by critiques from other schools of economics—what is the role of shareholder value, and at what point in time, in assessing corporations' performance and holding them accountable?

The most direct accountability mechanism is sound stewardship by the CEO and senior executives under the direction and oversight of hard-working, independent-minded boards of directors who are best positioned to balance the many competing interests at play in all significant corporate decisions. However, critics argue, with some force in some instances, that this accountability mechanism is weak because boards can be passive, complacent and inward looking, incapable of asking CEOs hard questions and ignoring important shareholder or other stakeholder concerns.

But the other accountability mechanisms—regulation, the market, enhanced shareholder role—are, in many respects, all aimed at the fundamental goal of my argument: strong, energized boards and business leadership dedicated to the discharge, in good faith, of the six essential functions in order to create durable long-term value through sustained economic performance, sound risk management and high integrity—and through meaningful consultation with shareholders and other important stakeholders.

In many policy papers, the cry goes up for "better leadership" to address difficult problems, with deep structural roots. Too often that plea goes unanswered—or the problems are too intractable. But today, with business facing a crisis in confidence about governance, it is in the demonstrable interest of corporations and of capitalism itself for boards of directors and business leaders truly to address the governance problems of the era and provide a clear, credible and powerful private sector response.

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